CONSUMER MORTGAGE COALITION

November 7, 2005

Mr. David A. Felt
Acting General Counsel
Office of Federal Housing Enterprise Oversight
1700 G Street, NW, Fourth Floor
Washington, D.C. 20552

RE: **Comments/Notice of Regulatory Review**

Dear Mr. Felt:

The Consumer Mortgage Coalition ("CMC"), a trade association of national mortgage lenders, servicers, and service providers, wishes to comment in response to the Notice of Regulatory Review, *Federal Register*, vol. 70, no. 172, p. 53105, published September 7, 2005. To the extent that the language of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 ("the 1992 Act") permits, we found that the current OFHEO regulations are well drafted and help place OFHEO within the context of other federal financial regulators.

Introduction and Overview

OFHEO's notice calls for comments on aspects of existing regulations that are inefficient or obsolete.[1] This notice, which seeks input on appropriate updates to regulations, is an example of a sound regulatory practice as most regulations need revisions over time. The CMC believes that revelations concerning developments at Fannie Mae and Freddie Mac ("the GSEs") in recent years show that there are indeed inefficiencies in part of the regulatory framework and that there is a need for the

[1] The Notice states:
"*Under the review process set forth in the Policy Guidance, criteria that may be used in the review of the existence of regulatory inefficiency or burden are as follows:*
(i) Legal or regulatory developments, including new laws, executive orders or judicial decisions that have been adopted since the promulgation of a regulation that make such regulation inefficient, obsolete, contrary to controlling legal precedent or unduly burdensome;
(ii) Application by an Enterprise for revision of a regulation, because of reasonably discernible regulatory burden or inefficiency;
(iii) Marketplace developments, technological evolution and related changes that may have rendered an existing regulation, in whole or in part, inefficient, outmoded or outdated; and
(iv) Such other occurrences or developments as determined by the Director or General Counsel to be relevant to a review for inefficiency or unwarranted regulatory burden." *Federal Register*, vol. 70, no. 172, at p. 53106.

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regulations to be strengthened. OFHEO should again invite public comment on the adequacy of its regulations once the final Special Examination Report on Fannie Mae and the Rudman Report on Fannie Mae have been published. Early press accounts seem to indicate that those reports could potentially reveal further shortcomings and demonstrate the need for more extensive regulatory improvements.

To the extent that OFHEO, in its discretion, were to decide that some of our comments might go beyond the contours of the Notice of Regulatory Review, please consider these comments to be a petition for regulatory action under the Administrative Procedure Act, 5 USC Sec. 553(e).

The CMC believes that current OFHEO regulations in the following areas deserve revision or addition because of developments that have revealed the existing framework to be obsolete or inefficient or that have rendered it so:

1. Safety and Soundness Regulation, 12 CFR Part 1720.
2. OFHEO's Role in GSE Program Approval
3. Rules of Practice and Procedure, 12 CFR Part 1780
4. Required Reports, Section 1314 of the 1992 Act, and Prompt Supervisory Response and Corrective Action, 12 CFR Part 1777
5. Authority to Provide for Review by Rating Organization, Section 1319 of the 1992 Act
6. Public Disclosure of Financial and Other Information, 12 CFR Part 1730

The CMC's Recommended Regulatory Revisions and Additions

The following are the CMC's proposed revisions or additions to current OFHEO regulations.

1. *Safety and Soundness Regulation*, 12 CFR Part 1720.

This regulation articulates OFHEO's policy guidance to the GSEs concerning safety and soundness and OFHEO's minimum supervisory standards.

Our recommended additions:

- *Guidance with respect to internal controls; portfolio growth*

  OFHEO's policy guidance on safety and soundness appropriately contains, in the section on Operational and Management Requirements, section B. V, of 12 CFR Part 1720, Appendix A, brief mention of issues concerning "Balance sheet growth and management." Given the recent problems besetting the GSEs in trying to manage and account for their large portfolios, the section on internal controls should amplify the issue.

  We have three recommendations in this regard. First, there is the issue of the rate of growth of the GSEs' portfolios. OFHEO should, as it may have done already, analyze the safety and soundness problems that arise when a GSE when grows its

portfolio rapidly.[2] OFHEO should then apply this analysis in a rulemaking process to prescribe limits to GSE rates of portfolio growth. There is direct legal support for this type of limitation in Section 304 (a) of the Fannie Mae Charter Act, which reads as follows:

> "The volume of the corporation's purchases and sales, and the establishment of the purchase prices, sale prices, and charges or fees, in its secondary market operations under this section, should be determined by the corporation from time to time, and such determinations should be consistent with the objectives that such purchases and sales should be effected only at such prices and on such terms as will reasonably prevent excessive use of the corporation's facilities…"[3]

Second, there is the issue of the size of the GSEs' portfolios. The size of the GSEs' portfolios should be reviewed on a regular basis, particularly in light of problems that have emerged with the management of the GSEs' portfolios, and also in light of changes in technology and the mortgage markets. Once again, Section 304 (a) of the Fannie Mae Charter Act provides direct legal support for OFHEO to impose such limits because of the GSEs' disregard of this legal requirement. Freddie Mac's charter act similarly permits the application of growth and size limits, and the 1992 Act requires OFHEO to ensure the safety and soundness of both GSEs.

Third, there is the issue of growth of GSE portfolios through non-mortgage investments. OFHEO should require reports from the GSEs, pursuant to Section 1314 of the 1992 Act, on the nature and amount of non-mortgage investments that they hold in portfolio. Then OFHEO should conduct and publish regular research reports, pursuant to its authority under Section 1313(b)(10) of the 1992 Act, on the amount of the GSEs' portfolio size and growth that can be attributed to non-mortgage investments, and the nature of those investments. The result of this public exposure is likely to be increased restraint by the GSEs in taking on more risk from portfolio operations unrelated to their statutory mission.

- *Guidance with respect to internal controls: unlawful acts*

OFHEO's policy guidance on safety and soundness already states appropriately, in the section on internal controls, section B. V, of 12 CFR Part 1720, Appendix A, that internal controls must be effective to assure "compliance with applicable laws, regulations, and policies." It would be advisable to add new language to clarify that *ultra vires* acts taken by a GSE, i.e., acts beyond the scope of its charter act, also represent failures of internal controls. The commentary should

[2] For example, the experience of the federal bank regulators is reflected in the "Interagency Guidelines Establishing Standards for Safety and Soundness," codified at 12 CFR Part 364, Appendix A, limiting institutions to "prudent" growth of their asset portfolios.
[3] Codified at 12 U.S.C. § 1719 (a).

explain that such acts may be void and unenforceable under law.[4] The commentary should also reiterate OFHEO's authority to require a GSE to cease and desist from any such acts. OFHEO has done this, for example, with respect to Freddie Mac's use of spread accounts in connection with the securitization or purchase of single-family conventional loans with high loan-to-value ratios.[5] In particular, OFHEO should state explicitly that failure to obtain prior HUD approval for new programs may be *ultra vires*, illegal, unsafe and unsound, and may subject a GSE to enforcement action.

- *Guidance with respect to reputational risk*

The Operational and Managerial Requirements section of the policy guidance should include a section on "reputational risk" to complement the sections on other types of risk (credit, interest rate, market, etc.).

Reputational risk has long been recognized as an important type of risk.[6] As a publication of the Federal Reserve Bank of Chicago points out, "Reputational risk is the potential that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions."[7]

One particular source of reputational risk for GSEs has been a perception that the GSEs use their political influence to try to prevent their regulator from taking appropriate regulatory actions,[8] and use their government-granted shared monopoly status to discriminate, in pricing and other business terms, against some business partners.[9]

This issue is a long-standing one. In his statement to the report of the House Committee on Banking, Finance and Urban Affairs with respect to the legislation that became the 1992 Act, Representative Jim Leach (R-IA) made the following observations:

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[4] See, e.g., *REW Enterprises, Inc. V. Premier Bank, N.A.*, 49 F3d 163 (5th Cir., 1995), concerning the ultra vires acts of an institution of the Farm Credit System, another GSE.

[5] See, letter from Anne E. Dewey, OFHEO General Counsel, to Maud Mater, General Counsel of Freddie Mac, October 10, 1996; and letter from Anne E. Dewey, OFHEO General Counsel, to Anastasia D. Kelly, General Counsel of Fannie Mae, October 10, 1996.

[6] Thus, the *Basel Core Principles for Effective Banking Supervision*, issued by the Basel Committee on Banking Supervision in September 1997, points out (p. 23) that, "Reputational risk arises from operational failures, failure to comply with relevant laws and regulations, or other sources. Reputational risk is particularly damaging for banks since the nature of their business requires maintaining the confidence of depositors, creditors and the general marketplace."

[7] "Legal/Reputational Risk – Banking Information," Federal Reserve Bank of Chicago, available at http://www.chicagofed.org/banking_legal_reputational_risk.cfm, accessed October 10, 2005.

[8] "With respect to the organizational culture issues that underlie these problems, see, e.g., Kenneth Posner, "Fannie Mae: Remain Equal-Weight," Morgan Stanley Equity Research North America, September 28, 2005, p. 2.

[9] This issue also relates to the need for internal controls that protect the GSEs against violations of the proscriptions of the Federal Trade Commission Act, 15 U.S.C., § 45 (a), discussed below.

> "[GSE] market dominance allows for heavy-handed approaches to competitors, to financial intermediaries, and to consumers. Competitors such as community based savings and loan associations and commercial banks are also users of GSE services. They are understandably apprehensive about expressing reservations about their practices in fear of retaliation. Likewise, would-be competitors such as securities firms run well known market risks if they object or attempt to compete with Fannie and Freddie. The two GSEs distribute billions of dollars of business on Wall Street and have a reputation of not cottoning to challengers of the status quo."[10]

It is important to address this aspect of reputational risk directly. OFHEO's policy guidance should, among other elements, proscribe discrimination, in pricing and other business terms, with respect to organizations with which the GSE may do business. The addition of appropriate language to a new section on reputational risk in 12 CFR Part 1720 would be advisable.

- *Guidance with respect to other unlawful acts: antitrust, unfair methods of competition, and unfair acts or practices*

The issue of GSE discrimination relates to the larger question whether the GSEs are engaging in anticompetitive or otherwise unfair behavior, for example in pricing their guarantee fees. OFHEO is already conducting an analysis of the pricing of GSE guarantee fees.[11] Needed in the OFHEO safety and soundness regulations is an express statement that OFHEO deems it to be a failure of internal controls for a GSE to engage in anticompetitive or other unfair or deceptive acts or practices in violation of the antitrust laws or the Federal Trade Commission Act. The Federal Trade Commission Act states unambiguously that:

> "Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are hereby declared unlawful."[12]

As OFHEO stated in its October 25, 2004, letter to Chairman Richard Baker, the issues of pricing and potentially anticompetitive or otherwise unfair behavior are especially important because of the market power of the GSEs as a result of their GSE status.[13]

2. *OFHEO's Role in GSE Program Approval*

The 1992 Act creates a curious bifurcation of responsibilities between OFHEO and HUD. While the HUD Secretary has authority under Section 1322 of the

[10]Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives (1991), page 115. (Dissenting views of Representative Jim Leach.)

[11] Letter of Armando Falcon, Jr., to the Honorable Richard Baker, October 25, 2004.
[12] Codified at 15 U.S.C. § 45(a).
[13] Letter of Armando Falcon, Jr., supra, note 11, pp. 2-3.

1992 Act to approve GSE programs, the Secretary lacks authority to enforce directly a decision to disapprove a GSE program. The Secretary also lacks powers to deal directly with GSE implementation of new programs in violation of the express language of their charter acts.[14] By contrast, OFHEO possesses authority, for example, through the cease-and-desist powers of Section 1371, to enforce violations of orders, rules, or regulations issued pursuant to the 1992 Act, and violations of the GSEs' charter acts and other laws, except as these relate to the GSE housing goals.

The CMC respectfully urges OFHEO to create an office of Ombudsman with authority to receive complaints concerning GSE programs. The Ombudsman could provide a place where members of the public could bring their complaints concerning GSE expansion to OFHEO's attention. OFHEO should assure complete confidentiality of such complaints; otherwise, as may be inferred from the discussion of GSE reputational risk, above, it may be difficult for people or organizations to share the information that OFHEO needs to do its work.

OFHEO could conduct its own inquiry, perhaps through the examination process, and could reach a determination as to whether a GSE was engaging in programs without first obtaining HUD approval, in violation of its charter act. A determination of a charter act violation would be enforceable by OFHEO.

Given the bifurcation of responsibilities under the 1992 Act, the creation of such an office and process at OFHEO appears to be one of the few ways that OFHEO can carry out its responsibilities with respect to the GSEs' adherence to the limits of their charter acts. In addition, given the importance of assuring that the GSEs remain within their congressionally authorized market segment, the internal controls section of the OFHEO regulation on Safety and Soundness, section B. V, of 12 CFR Part 1720, Appendix A, should be expanded to make express reference to the need for the GSEs to assure that they avoid violations of the program approval aspects of their charter acts.

3. *Rules of Practice and Procedure*, 12 CFR Part 1780

OFHEO's rules of practice regulation, 12 CFR Part 1780, is useful, but narrow. It currently applies to administrative enforcement proceedings. There is a need for an OFHEO regulatory provision to address matters such as requests by the GSEs for OFHEO's review, approval, or other action. This provision could be added to the rules of practice or else could be part of a new regulation.

In either event, the regulations should include a new provision that specifies that any request by a GSE for review, approval, or other action by OFHEO must be based on a *completed application*. OFHEO would notify the GSE, as soon as possible after the GSE files the application, as to what further information, certifications, or other items, if any, are required in order to make the application complete. The regulation

[14] See, Fannie Mae Charter Act, Section 302 (b)(6); and Freddie Mac Charter Act, Section 305(c).

also should specify that OFHEO shall notify the GSE when OFHEO deems the application to be complete so that any applicable timetable may begin. This is analogous to the procedures adopted by the Office of Thrift Supervision in 12 CFR Part 516. Section 516.45(b) which provides that OTS may notify an applicant that it has adjusted the application filing date if the applicant has failed to meet any applicable requirements.

4. *Required Reports, Section 1314 of the 1992 Act, and Prompt Supervisory Response and Corrective Action, 12 CFR Part 1777*

The high leverage and thin capitalization of Fannie Mae and Freddie Mac have long been the subject of policy attention. One area of significant agreement is that the risk-based capital tests of the 1992 Act are inadequate. As OFHEO itself has stated, "An Enterprise's maintenance of sufficient capital to meet the minimum capital level and risk-based capital level does not alone establish that the Enterprise possesses sufficient capital to operate safely and soundly in all circumstances."[15] Both the House and Senate GSE bills pending in the Congress would change the risk-based capital standard to remove the artificial constraints of the 1992 Act.

Regardless of whether the currently proposed legislation is enacted, it is appropriate for OFHEO to require the GSEs to report to OFHEO the level of capital needed to withstand scenarios that are more robust – and far more likely to occur – than the narrow and unrealistic scenarios that are used to set risk-based capital levels under the 1992 Act. This can help to obviate the problem that a GSE potentially could fail financially before it fails the current limited risk-based capital standard. OFHEO should prescribe scenarios that could cause depletion of capital, including credit risk, interest rate risk, and management and operations risk parameters, and require the GSEs to report on their ability to withstand these scenarios.

In addition, OFHEO should revise Section 1777.21 (b) (1) of its rule on "Prompt Supervisory Response and Corrective Action," 12 CFR Part 1777, to require each GSE to provide notice of any material development that would cause the GSE's core capital or total capital to fall below the point needed to meet any of the prescribed scenarios. OFHEO also should require the GSE to report such a material development publicly, as is discussed below. Failure to make such a report in a timely manner should be deemed to create reputational risk and raise a warning under the supervisory standards of 12 CFR Part 1720.

To help assure that OFHEO is prescribing the most appropriate scenarios, OFHEO should conduct public hearings from time to time to obtain public comment on the scenarios that OFHEO proposes to prescribe.

[15] Department of Housing and Urban Development, Office of Federal Housing Enterprise Oversight, "Prompt Supervisory Response and Corrective Action: Final Rule," *Federal Register*, vol. 67, no. 17, January 25, 2002, p. 3587.

Indeed, the CMC made a similar recommendation in its comments on the risk-based capital rule that OFHEO published in final form in 2001.[16] The CMC stated:

> "We urge OFHEO to perform additional scenario analyses on a regular basis and to publish the results. By conducting its own analysis of a wide variety of stress scenarios, OFHEO will enhance its ability to address issues …with respect to (1) the shape of the yield curve, (2) basis risk and the relationship of federal agency debt to Treasuries, (3) minimum prepayment speeds, (4) the home price inflation rate."[17]

The passage of time, and the need for OFHEO to require additional capital at both GSEs to deal with long-standing unreported internal control failures, shows that such scenario analysis, including consideration of management and operations risks, is long overdue as a layer of protection of GSE safety and soundness.

5. ***Authority to Provide for Review by Rating Organization, Section 1319 of the 1992 Act***

Section 1319 of the 1992 Act provides that,

> "The Director may, on such terms and conditions as the Director deems appropriate, contract with any entity effectively recognized by the Division of Market Regulation of the Securities and Exchange Commission as a nationally recognized statistical rating organization for the purposes of the capital rules for broker-dealers, to conduct a review of the Enterprises."

The CMC urges that OFHEO, on a biennial basis, employ the services of two rating agencies, each to conduct an assessment of the financial condition of each Enterprise for the purpose of determining the credit risk of obligations issued by each GSE, including senior obligations and subordinated obligations, without regard to any perception of ties of the GSE to the government or any form of financial backing other than is provided by the financial strength of the GSE by itself.

The quality of such a rating depends critically on the assumptions that the rating agencies use in their reviews; together with the rating agencies, OFHEO rather than the GSEs, should be the final arbiter of these assumptions. One important factor to include expressly in the review relates to the degree of cooperation that a GSE provides to the rating agencies in the course of their reviews.[18] To help assure the

[16] The rule has been codified, as amended, in Subpart B of 12 CFR Part 1750, "Risk-Based Capital."
[17] Letter from Anne C. Canfield, Executive Director, Consumer Mortgage Coalition, to Alfred M. Pollard, OFHEO General Counsel, April 14, 2000, "Risk-Based Capital; Second Notice of Proposed Rulemaking; Second Round of Comments," p. 5.
[18] The history of GSE failure to cooperate with the relevant regulators, including both OFHEO and HUD, has been well documented. The warning of equity analyst Kenneth Posner, cited in footnote 8, above, is relevant to the reputational risk that poor cooperation would entail.

quality of the assumptions used in each review, OFHEO should publish the assumptions from time to time for possible revision based on public comment.

6. ***Public Disclosure of Financial and Other Information, 12 CFR Part 1730***

The CMC urges that OFHEO expand its regulation on public disclosure of financial and other public information. As OFHEO mentions in the preamble to that rule, the disclosure of important financial information can contribute to safety and soundness by promoting market discipline.[19]

There are at least several express areas, relating to issues discussed above, where increased financial disclosure would help to promote market discipline:

- OFHEO should require the GSEs to disclose the extent of their reputational risk and any changes in factors that could affect that risk. See item 1, above.

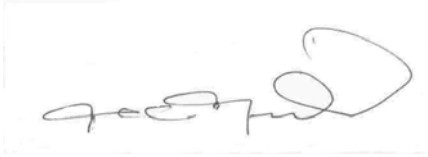
- OFHEO should require the GSEs to disclose any material development that would cause the Enterprise's core capital or total capital to fall below the point needed to meet any of the prescribed scenarios for assessing capital. See item 4, above.

- OFHEO should require the GSEs to disclose, in such form as OFHEO shall prescribe, the results of the reviews conducted by the rating agencies. See item 5, above.

Summary

In summary, the CMC strongly supports the strengthening of safeguards against unsafe and unsound and unethical practices that can undermine the financial strength and reputation of the GSEs, and their ability to meet their public mission. We thank OFHEO for its invitation to respond to the Notice of Regulatory Review and stand ready to assist with improvement of the effectiveness of GSE regulation in subsequent rulemaking processes.

Sincerely,



Anne C. Canfield
Executive Director

[19] "Public Disclosure of Financial and Other Information; Final Regulation," *Federal Register*, vol. 68, no. 66, April 7, 2003, p. 16716.